SEC Issues Additional Interpretive Guidance on Pay-versus-Performance Disclosures

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The Securities and Exchange Commission (the "SEC") has published nine additional Compliance & Disclosure Interpretations ("C&DIs") on the pay-versus-performance disclosures required by Item 402(v) of Regulation S-K. The SEC's guidance comes ahead of the second proxy season in which the pay-versus-performance disclosure is required for public issuers.

This Debevoise Update provides an overview of the SEC's new interpretive guidance. Our prior Debevoise In Depth provides detailed Q&As on the final pay-versus-performance disclosure rules, and our Debevoise Update from February 2023 summarizes the first set of C&DIs published by the SEC on this topic.

Equity Award Calculations. For each year in the pay-versus-performance table, the SEC's rules require the issuer to calculate "compensation actually paid" for the CEO and, on average, for the other named executive officers. To calculate compensation actually paid, the issuer starts with total compensation as reported in the summary compensation table and then makes the required adjustments for pension benefits and equity awards. For the equity award calculations, the first fair value disclosure of each award is made in the year of grant, and then changes in the fair value of the award are reported from year to year until the vesting date (or the date the issuer determines the award will not vest). The SEC's new guidance addresses interpretive questions related to these equity award calculations.

Two C&DIs cover the treatment of awards granted prior to an IPO, spin-off or other equity restructuring in the calculation of compensation actually paid:

- *Awards Granted Prior to an IPO.* The change in fair value of outstanding stock and option awards granted before a company's IPO should be based on their fair value at the end of the prior fiscal year, not the IPO date. (C&DI 128D.15)
- *Awards Modified in Connection with an Equity Restructuring.* Outstanding, unvested equity awards granted prior to an equity restructuring (such as a spin-off), and

modified in connection with the transaction or retained following such a transaction, should be included in the calculation of compensation actually paid. (C&DI 128D.14)

Four additional C&DIs address the meaning of "vesting" (and failing to vest) for purposes of calculating compensation actually paid:

- *Retirement Eligibility.* If retirement eligibility is the only vesting condition for a stock or option award, the vesting condition is considered satisfied when the holder becomes retirement eligible. However, for awards with additional substantive conditions in addition to retirement eligibility, these other conditions must also be considered to determine when an award has vested. (C&DI 128D.18)

- *Compensation Committee Certification as a Vesting Condition.* If certification by a compensation committee (or other individual or entity) is an additional substantive vesting condition of an award (e.g., if the employee must be employed on the date of certification to vest in the award), then the award is not considered vested until certification occurs, even if performance conditions are earlier met. (C&DI 128D.19)

- *Market Conditions.* Market conditions should be considered in determining whether the vesting conditions of share-based awards have been met (in addition to being reflected in the fair value of a share-based award subject to such a condition as required by FASB ASC Topic 718). Issuers must include in compensation actually paid the change in fair value of any awards subject to market conditions until the market condition is satisfied. Similarly, if failure to meet the applicable market condition during the covered fiscal year results in forfeiture of the award, issuers must deduct from compensation actually paid the fair value of such award at the end of the prior fiscal year. (C&DI 128D.16)

- *Awards that fail to meet vesting conditions in a specified year.* Awards that do not meet vesting conditions during a given year because performance or market conditions were not met but remain outstanding and could vest in the future should **not** have their fair value subtracted in calculating compensation actually paid. (C&DI 128D.17)

And two C&DIs address appropriate valuation methodologies:

- *Multiple Valuation Techniques*. Registrants may use a valuation technique for purposes of determining the fair value of an equity-based award in the calculation of compensation actually paid that is different from the technique used to determine the grant date fair value of such award, as long as the technique is permitted under FASB ASC Topic 718, including meeting the criteria for a valuation technique and the fair value measurement objective. If such valuation technique differs materially from that used to determine the grant date fair value, the issuer must disclose under

Item 402(v)(4) both the change in valuation technique from the grant date and the reason for the change. (C&DI 128D.20)

- *No Valuation Methodologies Not Prescribed by GAAP.* Fair value of stock and option awards must be computed using a methodology and assumptions consistent with FASB ASC Topic 718, and alternative methods that are not prescribed by U.S. GAAP are not acceptable. (C&DI 128D.21)

Other Guidance. The SEC also confirmed that an issuer is not required to disclose detailed quantitative or qualitative performance conditions for its awards in the required pay-versus-performance footnote disclosure[1] to the extent such information would result in competitive harm to the issuer pursuant to Instruction 4 to Item 402(b). (As a reminder, the SEC views the competitive harm standard as a high bar.) If an issuer relies on competitive harm to not disclose the performance conditions for its awards, the registrant must provide as much information as possible without disclosing the confidential information—e.g., a range of outcomes or a discussion of how a performance condition impacted the fair value. The registrant should also discuss how the material difference in the assumption affects the likelihood of the named executive officer and/or the issuer achieving undisclosed target levels or other factors. (C&DI 128D.22)

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[1] As a reminder, Item 402(v)(2)(iii)(C)(3) of Regulation S-K provides that "for any awards that are subject to performance conditions, calculate the change in fair value as of the end of the covered fiscal year based upon the probable outcome of such conditions as of the last day of the fiscal year." In addition, Item 402(v)(4) of Regulation S-K provides that "for the value of equity awards added pursuant to paragraph (v)(2)(iii)(C) of this section, disclose in a footnote to the table required by paragraph (v)(1) of this section any assumption made in the valuation that differs materially from those disclosed as of the grant date of such equity awards."

Please do not hesitate to contact us with any questions.

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